STEP BAHAMAS ANNUAL GENERAL MEETING

Buena Vista Restaurant
Thursday, May 30, 2002 - 12:30 p.m.

U.S. and Offshore Asset Protection Trusts Compared **©**

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I. Asset protection trust and their true function

A. Just another limited liability device

1. Charged atmosphere
2. Problem of abuse

a. When does a planning device become a conspiracy?
b. Overclaim and hype
c. Problem of settlor control
d. Thin line between lawful retention and alter ego
e. Sham trust

B. Central importance of asset protection form the income and estate tax perspective

1. Wholly discretionary trust as a completed gift for U.S. tax purposes

a. If, for example, a non-resident alien creates a trust which acquires U.S. real estate, this is a major device for reduction of income tax on gain on sale

b. Excludes trust corpus from taxable estate

2. Income tax impact in countries other than the U.S.

a. Mexico: lack of control
b. Venezuela: emerging consensus

3. Device for giving assets away but having a way of repossessing assets if need be

II. The issues involved in offshore trusts

A. The atmosphere

1. OECD initiatives

2. U.S. concerns about offshore operations. *See, e.g., Corporate Inversion Transactions: Tax Policy Implications,* Office of Tax Policy, U.S. Treasury Dept., May, 2002; *see also,* Comment by IRS on adoption of IRC foreign trust regulations. Reference to inappropriate use of offshore life insurance.

a) Actually, the Tax Information Exchange Agreement ("TIEA") ultimately should improve the atmosphere. However, the TIEA will not be effective until 2004.

3. Credit cards, etc.

B. Some tax issues which create apprehension

1. Complicated information reporting and heavy penalties for noncompliance. *See* IRC § 6677.

a) Trustee's problems of accounting on basis necessary to meet U.S. tax requirements

2. Snares for the unwary

a) Example. Wholly discretionary U.S. created foreign trust with U.S. beneficiaries may be completed gift for estate/gift tax purposes but transparent for income tax purposes (IRC § 679). When settlor dies there could be unexpected recognition of taxable gain. *See* IRC § 684. It may be possible to draft out of this problem. However, the consequences are anti-asset protection and not clear in any case. Note the 2001 Estate Tax Repeal Act provided that an exception would apply only if a U.S. person was treated as the grantor of the trust. This change does not take effect until 2010 and is subject to 2011 sunset.

b) Similar result could follow in the case of migration trusts where a foreign person makes a transfer in trust which is a completed gift before coming to U.S. but thereafter decides to leave U.S. or dies while a U.S. domiciliary.

III. Domestic (“DAPT”) and foreign asset protection trusts (“FADT”) compared

A. What are DAPT’s?

1. Background

a) Alaska - Alaska Trust Act, 1997 SLA Ch. 6
b) Delaware - Chap. 159, 71 Del Laws 452 (1997)
c) Nevada - Chap. 299, 1999 Nev. Stat. 1236
d) Rhode Island - Qualified Dispositions in Trust Act. Ch. 402 (1999)
e) Colorado - Colo. Rev. Stat. § 38-10-111 (1994)
f) Missouri - Mo. Rev. Stat. 8456, 080 (1989)

2. Substance

a) The trust created under the law of one of the above states

(1) At least one trustee must be a resident, domiciliary or domestic bank or trust company. Delaware appears to require one trustee who must be a Delaware individual or financial institution. However, trust protectors and investment advisors are specifically authorized.

(2) Some states require some assets to be located within the state and/or that books and records be located there.

(3) Neither the settlor nor a related party is the trustee

(4) Some part of the administration of the trust must be carried on in the state

(5) The Trust should contain a spendthrift clause and adopt the appropriate governing law.

b) These are wholly discretionary trusts which are “self-settled”, i.e., the settlor is a member of the class of permissible beneficiaries but not a mandatory beneficiary

c) The law in the above states reverses the general rule prevailing in the U.S., that a self-settled trust is exposed to the claims of creditors. Under the general rule, a Settlor is deemed to have an interest in a wholly discretionary trust to the maximum extent the Settlor may be benefitted under the trust under something called the maximum exercise rule.

B. Exposures of DAPT's not shared by FADT's

1. Full faith and credit exposure
2. Supremacy clause
3. Bankruptcy power

B. Other exposures that are shared but perhaps not to the same degree

1. Choice of law and public policy

2. Issues relating to jurisdiction and the location of property

3. Effectiveness of so-called spendthrift clause

a) Some states prevent spendthrift clause from interfering in creditors' rights only

b) Some states by statute or case law create an exception for martial or child support claims

c) Some states simply refuse to enforce these clauses as unreasonable restraints on alienation and contrary to public policy. New Hampshire recently refused to create an exception on public policy grounds where the legislature had spoken.

d) The Restatement covers all of these and also certain Tort claims and support creditors.

e) Federal bankruptcy law generally follows application state law

C. Certain domestic exposures to DAPT's not present in the foreign context

1. Exposure to debts for alimony or child support if under an agreement in effect before the effective date of the trust (Delaware, Rhode Island)

a) <u>Alaska exception</u>. At time of transfer in trust settlor was in default under child support order for 30 days or more

2. Claims for wrongful death or personal injury where the damage arose prior to transfer of assets in Trust (Delaware, Rhode Island)

3. Not present in Alaska or Nevada

4. Alaska exceptions from application of favorable rules

    a) Settlor has right to revoke or terminate all or part of trust without consent of an adverse party

    b) All or part of income or principal must be distributed to the settlor

    c) The transfer was intended in whole or in part to hinder, delay or defraud creditors

D. Other deviations

1. Statute of limitations generally shorter offshore than domestically and generally runs from date of transfer, not reasonable discovery, as is normally the case with domestic statues.

2. Standard of proof to prove fraudulent transfer generally will be higher offshore than domestically.

3. Limited exposure to foreign judgments

4. Thus, judgments may be entered domestically but can they be enforced offshore

IV. Further thoughts on tax possibilities of domestic trusts

A. Income and estate tax advantages dependent upon

1. No express or implied agreement that trust income or assets <u>will</u> be applied to or for the benefit of the settlor

2. Settlor's creditors cannot reach the trust property

B. Implied agreement

1. IRS has benefit of hindsight

2. Pattern of distributions raise presumption of agreement

3. Overgenerous applications of trust resources to the benefit of the settlor may have the same adverse effect. For example, continued residence in home owned by the trust.

C. Asset protection

1. Problems of uncertainty as to the application of the domestic asset protection rules. Not clear how this works in practice. What happens if the statute of limitations is open and then closes? Is this a transfer into an exempt state? What happens if the value of the property increases in the interim? What happens if statute is open as to a transfer on date of death?

2. Does the IRS share these doubts? In PLR 9332006, the IRS ruled that a transfer to a wholly discretionary foreign trust created in an asset protection foreign jurisdiction, would be treated as a completed gift terminating estate tax exposure as to the transferred property. However, in PLR 9837007, the IRS in a similar factual situation involving a DAPT, refused to rule as to the estate tax aspect. What do these rulings portend?

a) The rulings accept the existence of asset protection without analyzing applicability of legal protection in individual case. This is a snare for the unwary because such analysis may be applied where a case is being audited.

b) The rulings should not be read as according greater potency to FAPT's from the tax perspective than is the case with DAPT's.

c) The difference in approach in the two rulings represents the passage of time and a change in policy regarding IRS willingness to rule upon future events where the actual outcome rests on factual analysis. Simply, the IRS is unwilling to rule as to future estate tax efficiency of APT's on death of the settlor, where a taxpayer's favorable outcome depends on whether the prohibited express or implied agreement existed on date of death.

D. Avoidance of snares in the case of foreign trusts

1. It is now relatively easy for foreign trusts to be treated as domestic for tax purposes, thereby avoiding the tax snares referred to above

2. However, the cost is likely loss of asset protection. Thus, a U.S. trust is only a trust where a U.S. court is able to exercise primary

jurisdiction over the administration of the trust AND one or more U.S. persons have the authority to control all substantial decisions of the trust. IRC § 7701(a)(30)(E). The trust can be structured to meet these requirements even if there are foreign trustees and even if a foreign court can also exercise primary jurisdiction over the administration of the trust. This dual status trust by virtue of the U.S. exposure is likely to lose asset protection. Historically, offshore trusts were set up to qualify as U.S. situs trusts until an asset protection crisis arose when they would flee offshore. This flight could be very expensive taxwise; but it was considered that the flight was worth the cost. In 1996/97 this standby approach was made more difficult and less favorable from an asset protection perspective. Nevertheless, it is still employed by some planners. Bear in mind that certain types of flee clauses can have a material adverse effect.

E. Possible use of a foreign trust for a QDOT

1. There are certain areas where a domestic trust is generally mandatory. The U.S. still imposes estate tax at the highest effective rate of approximately 48% (2002 rates). While the effective rates will decline and disappear altogether in 2010, no one expects this to happen. The estate tax is mitigated by an unlimited marital deduction for the value of all property passing to a surviving spouse. This deduction is denied where the surviving spouse is not a citizen of the U.S. The tax otherwise imposed is, however, deferred where the property left to a non-citizen surviving spouse is left in a qualified domestic trust ("QDOT"). This deferral is available not only to U.S. persons but to foreigners dying and owning U.S. situs property subject to U.S. tax.

2. While it is not widely known, it may be possible for a foreign trust to be substituted for a U.S. trust in accordance with regulations (not yet proposed). It is understood that the regulations when issued will allow foreign trustees in circumstances where the IRS is satisfied that the QDOT tax ultimately due will be paid. The regulations currently provide that a QDOT must be a trust. This, too, is to be modified by regulations. The regulations also now provide that: "The trust may be established . . . pursuant to an instrument executed under the laws of a foreign jurisdiction, such as a foreign will or trust, provided that such foreign instrument designates the law of a particular state of the United States or the District of Columbia as governing the administration of the trust, and such designation is effective under the law of the designated jurisdiction." Treas. Reg. § 20.2056A-2(a). This provision too must be altered to give effect to the use of a foreign trust.

V. Conclusion

The use of DAPT may have significant domestic (U.S.) Tax planning uses. However, since its asset protection efficacy is doubtful, its tax planning utility is likewise doubtful. The FAPT is still the trust form of choice, both from an asset protection and tax viewpoint.